

THE IMPACT OF
THE LATIN AMERICAN DEBT CRISIS
ON THE U.S. ECONOMY

A STAFF STUDY

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The Latin American debt crisis first burst upon the public consciousness in August 1982, when Mexico announced that it could not continue paying interest on its current debt obligations. By the end of the year, it became clear that Mexico was only one of nearly a dozen Latin American nations that had borrowed considerably more from U.S., European, and Japanese banks than their sluggish economies were capable of repaying on time.

When Mexico's financial difficulties first became front-page news, Latin American debtor nations had a total external debt of more than \$318 billion, with yearly interest payments totaling \$38.5 billion. Their trade surplus at the time was only \$8.5 billion, or \$30 billion less than they needed merely to pay interest.1/ And they needed tens of billions of additional dollars in order to repay the principal on time.

Most of Latin America's external debt was owed to a relatively small number of international commercial banks. According to a recent Department of State report, private creditors in 1982 accounted for 85 percent of Latin America's external debt. Official debt, such as loans from the International Monetary Fund (IMF), the World Bank, and the U.S. Government, made up the remainder.2/

U.S. commercial banks were especially vulnerable to economic developments in Latin America. With a total 1982 exposure of \$83.9 billion, they held more than 25 percent of Latin America's

total debt and nearly one-third of the debt owed to all private creditors.^{3/} But as daunting as these numbers may be, they do not convey the full extent of the U.S. commercial banking system's stake in the Latin American debt crisis.

By the end of 1982, the U.S. commercial banking system's total exposure in Latin America equaled 119 percent of the total capital for all major banks. The Latin American exposure of nine money center banks equaled 176 percent of their combined capital. A bank is declared insolvent and closed by U.S. bank regulators when its loan losses consume its capital. Consequently, on average, all nine money center banks would have failed if the Latin American debtors announced they could repay only 40 percent of their outstanding debt. Even if they said that they would repay as much as 80 percent of the outstanding debt, the nine money center banks stood to lose more than 35 percent of their combined capital. Their ability to continue functioning and extending credit to U.S. borrowers would be seriously impaired. Clearly, U.S. officials were correct in perceiving that the debt crisis was a serious threat to the U.S. banking system -- and to the U.S. economy.

In early 1983, Administration officials devised a four-pronged strategy for ensuring that Latin American debtors would continue servicing their debts:^{4/}

- * Debtor nations would generate a large portion of the dollars they needed to pay interest by increasing their exports and cutting their imports;

- * Debtor nations would be given more time -- in some cases, as much as 14 additional years -- in which to repay their maturing loans;
- * Commercial banks would make new loans so that debtor nations could avoid falling behind on their interest payments to the banks; and
- * The IMF, in addition to lending modest amounts of its own funds, would ensure that the debtors were implementing essential economic reforms.

All three groups -- the banks, the debtor nations, and the IMF -- announced that they intended to comply with this strategy. Latin American debtors, for example, reduced their imports from almost \$100 billion in 1981 to approximately \$60 billion today.^{5/} Most debtor nations also increased the volume of their exports. Since the beginning of this decade, the three largest Latin American debtors -- Argentina, Brazil, and Mexico, which together account for two-thirds of the region's total external debt -- increased the volume of their exports by 47 percent, 56 percent, and 62 percent, respectively.^{6/}

In addition, commercial banks and the IMF extended new loans to help debtor nations pay interest on their old loans. As a result, Latin America's outstanding debt increased by \$50 billion since the onset of the debt crisis -- it is now \$368 billion -- and according to the plan announced last October by Treasury Secretary Baker in Seoul, Korea, it is scheduled to continue

rising for at least the next three years. Finally, the major Latin American debtors have adopted austere economic reform programs and agreed to extensive IMF monitoring of their economic policies and performance.

It was clear from the outset that the third world debt problem posed a serious, potentially even catastrophic, threat to the stability of the international financial system. Thus far, a financial catastrophe has been averted, which was the initial goal of policymakers. The evidence suggests, in fact, that the policies that were implemented have permitted U.S. banks to maintain and even increase their profitability. But, at the same time, those policies have seriously -- and unnecessarily -- injured the economic well-being of other sectors of the U.S. economy, agriculture and manufacturing in particular. And they have done little to permanently resolve the debt crisis.

INJURY TO THE U.S. FARM ECONOMY

The financial crisis down on the farm is well documented. Little attention, however, has been paid to the relationship between the international debt crisis and the financial difficulties of U.S. farmers.

Declining Farm Exports

There are several ways in which the international debt crisis injures U.S. farmers. First and most immediately apparent is the

decline in farm exports to Latin America. In 1981, for example, the U.S. Department of Agriculture reported:

Developing countries continue to be the major growth area for U.S. farm exports. In Fiscal Year 1981, U.S. exports to these areas increased 19 percent to reach \$16.9 billion. Annual growth was sustained at over 20 percent between Fiscal Years 1977 and 1981....Over half of U.S. wheat and soybean oil and four-fifths of U.S. rice exports went to developing countries in Fiscal Year 1981.7/

As a result of sales to these third world markets, U.S. farm exports hit an all-time high in 1981, totaling \$43.8 billion. Without that agricultural trade surplus, the 1981 U.S. trade deficit would have been twice as large. Latin America's contribution to that export boom was considerable. It was the third largest market for U.S. farm exports, trailing only Western Europe and Japan. Between 1980 and 1981, the Latin American market absorbed almost one-half the total growth of U.S. farm exports.

When the debt crisis emerged in August 1982, however, Latin American markets contracted precipitously. In order to obtain dollars to pay interest on their external debt, debtor nations began reducing their purchases of all U.S. exports. Not surprisingly, this had dire consequences down on the farm.

At their peak in 1981, Latin American purchases of U.S. farm products totaled \$6.9 billion, or 15 percent of total U.S. farm exports. In the wake of the debt crisis, however, U.S. agricultural exports to Latin America tumbled one-third below their 1981 level, to \$4.5 billion. Nearly 20 percent of the

total decline in U.S. farm exports during those four years was the result of dwindling sales to Latin America.^{8/}

To get a clearer picture of the importance of Latin American markets to U.S. farm prosperity, it is instructive to note that, at their respective peaks, U.S. exports to Latin America exceeded exports to the Soviet Union by 240 percent, or \$4 billion. By 1985, U.S. agricultural exports to Latin America were \$2.4 billion below their peak; sales to the Soviet Union, meanwhile, were only \$500 million below their peak. In other words, by 1985, the Latin American debt crisis was nearly five times as damaging to U.S. farmers as reduced sales to the Soviet Union.^{9/}

Falling Commodity Prices

The reduction of agricultural exports to Latin America is only one way in which the debt crisis is injuring U.S. farmers. In order to pay interest, debtor nations must increase their exports as well as reduce their imports. In other words, they must purchase less from the United States at the same time that they are producing more and competing more fiercely with U.S. producers for a share of world export markets. This is the second way in which the debt crisis damages U.S. farm prosperity.

This additional production and competition cuts into U.S. sales to non-debtor nations and places downward pressure on virtually all major commodity prices. Falling commodity prices, in turn, make it more difficult for U.S. farmers to continue servicing their debt and pushes many of them into bankruptcy. At

the same time, falling commodity prices also makes it more difficult for Latin American debtors to continue servicing their debt. And as their debt service difficulties mount, they are pressed to produce and export still more which, in turn, generates additional price declines and increases the financial strains on U.S. farmers. In other words, in the current international economic environment of high debt burdens and global overproduction, falling commodity prices are as much a consequence of the debt crisis as a cause of the debt crisis.

This vicious circle is not limited to agricultural commodities. Petroleum, tin, and copper have also experienced major price declines caused by worldwide overproduction. And although falling oil prices have received the bulk of the recent public attention, during most of this decade prices have tumbled for nearly every commodity exported by debtor nations.

Between October 1980 and October 1982, prices for all non-petroleum commodity exports declined 40 percent. After three years of economic recovery, the downward slides seem to be continuing. In 1985, world sugar prices dropped by 26.9 percent, wheat prices declined by nearly 10 percent, corn prices fell by 19.2 percent, and soybeans declined in value by 19.0 percent. In each case, world market prices in 1985 were below their 1982 level and, in many cases, real commodity prices are at their lowest level in four decades.^{10/} Commodity prices have continued falling during the first four months of 1986 and, even excluding

petroleum, showed no signs of reversing their relentless decline any time soon.

The significance of falling commodity prices can be seen in Table 1, which compares the change in the volume of each country's exports with the change in its export revenues and external debt. For virtually every country, the story is the same: since the beginning of this decade, the external debt grew faster than export revenues, but the lag in export receipts cannot be attributed to an unwillingness of the debtors to boost their export volume. Rather, the failure of export revenues to keep pace is due almost entirely to falling commodity prices.

Global Overproduction

Many Americans are under the impression that the current farm crisis is due primarily to domestic overproduction. However, U.S. production and export statistics tell a different story.

For instance, while U.S. wheat production was increasing by six million metric tons (6 MMT) between 1981 and 1985, global wheat production was increasing by 75 MMT, or nearly 12 times as much (Table 2). During the same period, U.S. soybean output declined by 4 MMT, or 8 percent, while world output was rising by 2.7 MMT, or 5 percent. Indeed, U.S. soybean production has remained relatively constant in the 50 MMT range since 1978. Meanwhile, world production increased by 15 percent. Similarly, while world corn output increased by 22 MMT since the beginning of the decade, U.S. output was falling by 6 MMT, or 3 percent.

TABLE 1
CHANGES IN EXPORT VOLUME, EXPORT REVENUES,
AND EXTERNAL DEBT, 1980-1985

Country	Percent Change Volume Of Exports 1980-1985	Percent Change Export Revenues 1980-1985	Percent Change In Total External Debt 1980-1985
Argentina	47	3	46
Bolivia	-35	-38	31
Brazil	56	25	33
Chile	21	-23	43
Dominican Republic	8	-17	33
Ecuador	39	9	37
Mexico	62	34	41
Peru	- 3	-24	30
Uruguay	1	-20	57
Venezuela	-21	-25	13

Source: Economic Commission for Latin America, Preliminary
Overview of the Latin American Economy 1985,
December 1985, Table 7 and Table 15.

TABLE 2
PRODUCTION OF SELECTED COMMODITIES, 1977-1985

Year	(Millions Of Metric Tons)					
	Corn		Wheat		Soybeans	
	U.S.	World	U.S.	World	U.S.	World
1976-1977	157.9	336.3	58.5	421.2	47.9	72.1
1977-1978	161.8	364.9	55.7	384.2	50.8	77.2
1978-1979	184.6	390.0	48.3	446.8	61.7	93.7
1979-1980	201.7	423.7	58.0	423.3	48.7	80.8
1980-1981	168.8	406.7	64.6	441.1	54.4	86.2
1981-1982	208.3	437.4	76.1	448.2	61.9	95.2
1982-1983	213.3	437.7	76.4	472.9	44.5	82.3
1983-1984	106.0	350.0	65.9	489.4	50.6	89.7
1984-1985	194.5	445.3	70.6	516.0		

Source: Commodity Research Bureau, Commodity Year Book, 1983 and 1985 editions.

Rising world production levels helped spark the dramatic decline in U.S. farm exports. The volume of U.S. agricultural exports peaked in 1980 at 163.9 MMT and then fell by 40 MMT, or 25 percent, between 1980 and 1985 (Table 3). Export volume is projected to decline by an additional 4 or 5 percent in 1986. In the wake of this protracted decline, 1985's export volume is now below the 1978 level.

The value of U.S. farm exports also declined precipitously. After growing at a 17 percent annual rate between 1978 and 1981 and peaking at \$43.8 billion, agricultural exports fell at a 7 percent annual rate starting in 1982. This downward trend is projected to continue in 1986 at more or less the same pace. At \$31.2 billion, export revenues are at their lowest level since 1979.

TABLE 3
TRENDS IN U.S. FARM EXPORTS, 1977-1985

Year	Volume (MMT)	Value (Billions of \$)
1977	111.9	\$24.0
1978	131.9	27.3
1979	137.4	32.0
1980	163.9	40.5
1981	162.6	43.8
1982	157.9	39.1
1983	144.8	34.8
1984	143.6	38.0
1985	125.7	31.2

Source: Congressional Research Service, Patterns in Trade of Selected U.S. Agricultural Exports, Report #86-510, January 30, 1986, Table 2 and 3.

Increased Latin American Grain Exports

Although it would be an oversimplification to attribute these declines solely to the international debt crisis, it would be equally misleading to ignore the enormous impact of the crisis on world commodity markets since 1982. While U.S. production and exports have been declining, debtor nations in general, and Argentina and Brazil in particular, have greatly expanded production and, as statistics concerning the increasing incidence of malnutrition in both countries indicate, they have increased their exports even more rapidly than production. In large measure, their success in boosting exports has come at the expense of U.S. farm exports.

During the 1981/1982 crop season, for example, world wheat exports were 101.3 MMT. The United States supplied 48 percent of the world's wheat exports and Argentina supplied only 4 percent. By the 1984/1985 season, world wheat exports had risen 7 percent, to 108 MMT. U.S. exports, however, had fallen in absolute terms by 10.7 MMT and, in relative terms, to 35 percent of the world wheat market. Meanwhile, Argentine exports were doubling to 8.6 MMT.11/

Soybean exports show a similar trend. Between 1981/1982 and 1984/1985, world soybean exports declined by 4.4 MMT, or by 15 percent. U.S. soybean exports fell 36 percent, or by 9 MMT. Meanwhile, Brazilian soybean exports were quadrupling and Argentina's were doubling. Together, they now constitute 27 percent of the world soybean market, up from only 9 percent three

years earlier.^{12/} Meanwhile, a recent report from Sao Paulo, Brazil, indicates that the number of malnourished Brazilian children increased by 23 million over the past 10 years.^{13/} And in virtually all debtor nations, a typical IMF adjustment program calls on debtor nation governments to reduce domestic food price subsidies, thereby restricting domestic food consumption and contributing to the growing incidence of malnutrition.

Farm Bank Failures

Because the Latin American debt crisis has seriously injured U.S. farmers, it has also contributed to the collapse of numerous farm banks.

The number of farm bank failures rose by nearly 900 percent between 1982 and 1985 (Table 4). By 1985, more than 50 percent of total bank failures in the preceding three years were farm banks, even though only 25 percent of all commercial banks are classified as farm banks. In addition, from 1984 to 1985, the number of bank failures rose from 79 to 120. Approximately 90 percent of the increase was due to the higher incidence of farm bank failures.^{14/} And according to recent Federal Reserve Board analysis, anywhere between 400 and 1,400 additional farm banks are in danger of failing in the near future.^{15/}

TABLE 4
BANK FAILURES, 1982-1985

Institution	1982	1983	1984	1985
Agricultural Banks	7	7	25	62
Other Commercial Banks	27	38	53	56
Savings Banks	<u>8</u>	<u>3</u>	<u>1</u>	<u>2</u>
Total	42	48	79	120

Manufacturing businesses and their employees are also victims of the international debt crisis. According to recent estimates, more than one million U.S. jobs have been lost because the debt crisis has forced debtor nations to reduce their consumption of U.S. products and increase their exports of competing products to the United States.16/

BANK PERFORMANCE SINCE THE DEBT CRISIS

The use of public policy to prevent the debt crisis from sparking failures among the money center banks represents, in many respects, a significant philosophical departure for the Reagan Administration. From the beginning, their debt crisis policy was overtly interventionist. This marked a striking departure from the Administration's professed laissez-faire principles which, if applied consistently, would have permitted the banks to fail. Instead of trusting the invisible hand to solve the debt crisis, the Reagan Administration marshalled the power of the Federal Government and the resources of the U.S. Treasury to preserve the solvency of the U.S. banking system and shelter individual banks from the consequences of their ill-advised lending decisions. Most experts agree that the Administration should be applauded for its willingness to abandon its free market ideology when that ideology showed every indication of threatening the safety and soundness of the international and U.S. financial systems.

But the decision to intervene and avert a financial collapse was only a first step. The second step should have been to consider -- and minimize -- the impact of the debt crisis on the U.S. economy. Unfortunately, there is little evidence that the policies implemented since August 1982 were subjected to this second step procedure.

Preserving Solvency or Promoting Profitability?

Indeed, it is now becoming clear that Administration policies have gone above and beyond what was needed for protecting the money center banks from insolvency. Besides preserving their safety and soundness, the Administration ensured, and in fact promoted, their profitability. Comparing the fortunes of stockholders in the money center banks with those of American farmers and manufacturing exporters indicates that the Reagan Administration's management of the debt crisis has, in effect, rewarded the institutions that played a major role in precipitating the crisis and penalized those sectors of the U.S. economy that had played no role in causing the debt crisis.

From the outset, the Administration made only one request of the banks -- that they continue lending modest amounts of new money to hard-pressed debtor nations. This request was in the banks' self-interest. Without new bank loans, debtor nations would be have difficulty making timely interest payments. And if debtors failed to continue servicing their bank loans, reported bank profits would fall.

The money center banks' record of compliance has been less than enthusiastic (Table 5). Between June 30, 1982, and December 31, 1985, the nine money center banks increased their loans to Mexico by \$0.64 billion, and to Brazil by \$3.8 billion. During the same period, they increased their loans to Argentina by \$0.5 billion and to Chile by \$0.7 billion. They decreased their loans to Venezuela by \$0.2 billion. From the beginning of the debt crisis to the end of 1985, the nine money center banks increased their total Latin American exposure by only \$1.8 billion. This amounts to a 3.5 percent increase in three years.

Benefits to Bank Stockholders

Even though these nine banks provided a meager amount of the new money that was used to alleviate the debt crisis, their stockholders have clearly been the major -- indeed, possibly the only -- beneficiaries of Administration policies.

TABLE 5

NINE MONEY CENTER BANKS' EXPOSURE TO
MAJOR LATIN AMERICAN DEBTOR NATIONS, 1982-1985

Country	(Millions of Dollars)				
	June 30, 1982	Dec. 31, 1982	Dec. 31, 1983	Dec. 31, 1984	Dec. 31, 1985
Argentina	\$ 5,331	\$ 5,125	\$ 5,354	\$ 5,270	\$ 5,874
Brazil	11,775	13,296	14,127	15,397	15,550
Chile	3,364	3,327	3,439	3,823	4,067
Columbia	1,859	2,225	2,524	2,147	1,923
Mexico	13,443	12,862	13,298	14,553	14,087
Venezuela	7,313	7,804	7,636	7,456	7,127

Source: Federal Financial Institutions Examination Council, Country Exposure Leading Survey.

From the earliest days of the debt crisis, banks increased their spreads -- the difference between the interest rate they charge on loans and the interest rate they pay for loanable funds -- on loans to the most financially hard-pressed debtor nations. In 1980, spreads on syndicated Eurodollar loans to developing countries averaged 86 basis points. (A basis point is one one-hundredth of a percentage point.) Oil exporting developing countries like Mexico and Venezuela were borrowing money on even more favorable terms. In 1980, their spreads were as low as 66 basis points.^{17/} By 1983, however, while the U.S. Government and IMF were making emergency loans to keep debtor nations solvent, banks were tripling the spread they were charging on rescheduled loans to these same borrowers, raising them to more than 225 basis points. Since 1983, spreads have been reduced somewhat. But at 125 basis points, they are still averaging nearly 50 percent more than their pre-debt crisis level.^{18/}

These higher profit margins on loans to debtor nations were quickly translated into higher profits at the money center banks. During 1985, for example, after-tax profits rose by 12 percent at Citicorp, 39 percent at Chase Manhattan, 16 percent at Manufacturers Hanover, 31 percent at Morgan Guaranty, 15 percent at Chemical, 21 percent at Bankers Trust, and 96 percent at First Chicago (Table 6). Continental Illinois converted a \$1 billion loss in 1984 into a \$134 million profit in 1985. Bank of America was the only member of the top nine to register a loss.

TABLE 6

NET INCOME AT NINE MONEY CENTER BANKS, 1982-1985

Money Center Bank	(Millions of Dollars)			
	1982	1983	1984	1985
Bankers Trust	\$ 223	\$ 257	\$ 307	\$ 371
Bank of America	395	390	346	-337
Chase Manhattan	307	430	406	565
Chemical	241	306	341	390
Citicorp	723	860	890	998
Continental Illinois	84	101	-1,088	134
First Chicago	137	184	86	169
Manufacturers Hanover	295	337	353	407
Morgan Guaranty	<u>394</u>	<u>460</u>	<u>538</u>	<u>705</u>
Total	\$2,799	\$3,325	\$2,179	\$3,402

Source: Salomon Brothers, Inc., A Review of Bank Performance: 1986 Edition. For Continental Illinois, "Annual Scoreboard of 200 Banks," Business Week, various issues.

Their 1985 performance was not an aberration. Bank profits have grown steadily since the onset of the debt crisis. Between 1982 and 1984, after-tax income rose by \$167 million at Citicorp, \$99 million at Chase Manhattan, \$58 million at Manufacturers Hanover, \$144 million at Morgan Guaranty, \$100 million at Chemical, and \$84 million at Bankers Trust. Profits during this period did decline at Bank of America, First Chicago, and Continental Illinois. But it would appear that these declines occurred because of banking decisions unrelated to Latin American lending and in spite of the Administration's debt crisis policies, since none of the banks suffered significant losses on the syndicated loan portion of their Latin American portfolio.

Not surprisingly, bank stock prices and dividends increased along with profits. Total dividends increased by nearly 33 percent in the three years following the onset of the debt crisis, rising from a total payout of approximately \$1.2 billion in 1982 to almost \$1.6 billion in 1985 (Table 7). This increase, moreover, cannot be attributed solely to an increase in the number of shares outstanding. Dividends per share were also growing. At Bankers Trust, Chemical, Citicorp, and Morgan Guaranty they grew at a compound annual rate of approximately 9 percent.

TABLE 7
TOTAL DIVIDENDS DECLARED, 1982-1985

Money Center Bank	(Millions of Dollars)			
	1982	1983	1984	1985
Bankers Trust	\$ 71.2	\$ 81.0	\$ 92.0	\$ 106.6
Bank of America	229.4	291.5	307.5	246.7
Chase Manhattan	162.4	173.1	209.3	229.4
Chemical	103.8	129.8	150.0	155.8
Citicorp	222.0	271.0	319.0	353.0
Continental Illinois	80.0	83.0	25.0	0.0
First Chicago	50.9	73.3	93.1	94.6
Manufacturers Hanover	125.4	154.4	196.2	197.7
Morgan Guaranty	<u>136.0</u>	<u>168.0</u>	<u>190.0</u>	<u>210.0</u>
Total	\$1,181.1	\$1,425.1	\$1,582.1	\$1,593.8

Source: See Table 6.

In addition to receiving higher dividends, shareholders also profited from a substantial increase in stock prices (Table 8). With the exception of Continental Illinois and Bank of America, share prices rose at the seven other money center banks. A portfolio consisting of 100 shares of each of the nine money center banks would have increased in value from \$23,658 at the end of 1982 to \$32,509 at the end of 1985, and \$39,214 on April 30, 1986, even after the price declines on Continental Illinois stock are factored into the calculations.

THE BAKER PLAN

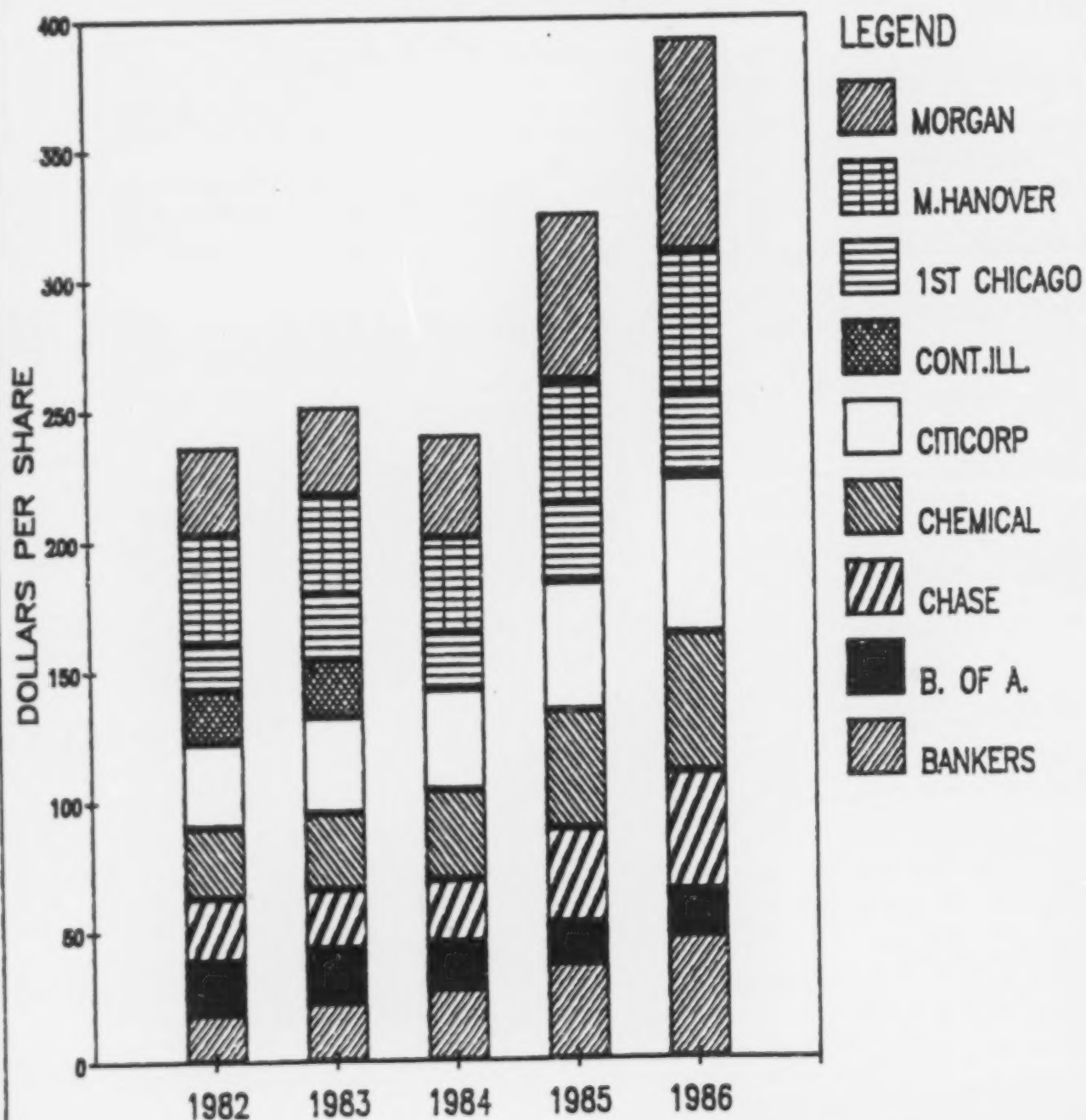
The Administration is now putting forward a new initiative, the Baker Plan.^{19/} It argues that this initiative is a dramatic departure from previous policies because it shifts the emphasis from austerity to growth. In particular, the Baker Plan calls on commercial banks to make \$20 billion of new loans, debtor nations to continue making structural economic adjustments, and the World Bank to make \$9 billion of new loans that were formerly made by the IMF.

TABLE 8
MARKET PRICE PER SHARE OF COMMON STOCK, 1982-1986

Money Center Bank	Dec. 31, 1982	Dec. 31, 1983	Dec. 31, 1984	Dec. 31, 1985	April 30, 1986
Bankers Trust	\$18.56	\$22.56	\$27.38	\$36.75	\$47.25
Bank of America	20.13	20.88	18.13	15.63	17.25
Chase Manhattan	24.50	22.75	23.88	36.31	45.63
Chemical	27.00	29.33	34.50	45.38	53.25
Citicorp	32.50	37.13	38.75	49.38	59.75
Continental Illinois	20.38	21.88	0.50	0.88	2.00
First Chicago	18.13	25.38	21.38	29.50	30.75
Manufacturers Hanover	41.63	38.00	36.63	47.13	54.13
Morgan Guaranty	33.75	33.69	39.25	64.13	82.00

Source: Same as Table 6.

STOCK PRICES OF NINE MONEY CENTER BANKS (SEE TABLE 8)



PREPARED BY THE JOINT ECONOMIC COMMITTEE

Aside from changing the rhetoric from austerity to growth and shifting responsibility from the IMF to the World Bank, it does not appear that the Baker Plan differs significantly from existing policy. In particular, it is doubtful that the amount of increased lending called for by the Baker Plan will be sufficient -- absent other initiatives relating to the conditions of debt service -- either to reduce current pressures on debtor nations to expand exports or permit them to boost their growth, investment, and imports.

Growth or Interest Payments?

As the financial data presented in Table 9 reveal, except for the Dominican Republic, all the major Latin American debtor nations are generating large trade surpluses. In Argentina, Brazil, and Venezuela, exports were at least twice as large as imports. In other words, with a more conducive external debt environment, these countries could have doubled their imports. Most of the other countries could also boost their imports substantially. The amount ranges from 14 percent in Uruguay to 61 percent in Peru. In dollar terms, the total trade surplus of these 10 Latin American debtors is \$35.6 billion. Since a large part of that trade surplus was generated by reducing their purchases of U.S. products, it stands to reason that U.S. exporters and their employees would benefit the most from a revision of Administration policies.

TABLE 9
FINANCIAL INDICATORS OF MAJOR LATIN AMERICAN
DEBTOR NATIONS, DECEMBER 31, 1985

Country	(In Millions)					
	(1) Goods Exports	(2) Goods Imports	(3)=1-2 Trade Balance	(4) Interest Payments	(5) Current Account	(6) Total Debt
Argentina	8,300	3,680	4,620	5,510	-1,600	50,000
Bolivia	580	430	150	430	- 370	3,190
Brazil	25,200	12,800	12,400	11,540	- 700	101,930
Chile	3,640	2,930	710	1,820	-1,350	19,580
Dominican Republic	800	1,090	-290	300	- 200	2,760
Ecuador	2,770	1,730	1,040	840	- 140	7,300
Mexico	21,500	13,500	8,000	9,000	- 550	97,700
Peru	2,970	1,860	1,110	1,220	- 230	13,750
Uruguay	850	740	110	350	- 200	4,900
Venezuela	14,300	6,600	7,700	1,520	+4,400	30,300

Source: Economic Commission of Latin America, Preliminary Overview of the Latin American Economy 1985, December 31, 1985, Tables 12, 13, and, 15.

However, because of their debt service expenses, debtor nations cannot afford to increase their imports. In fact, as column 4 indicates, additional rounds of import restrictions and export promotion will probably be required if debtor nations are to continue paying interest. With the exception of Ecuador and Venezuela, interest payments exceed the trade surplus in every Latin American nation. (These data precede the recent interest rate and oil prices declines which have improved the position of Argentina and Brazil and worsened that of Ecuador, Venezuela, Peru, and Mexico.)

To make matters worse, the difference between the merchandise trade balance and interest payments underestimates the additional import restraints each country must impose. In addition to merchandise imports, every country must also pay for various other items, such as insurance, freight, and legal and accounting services. Subtracting the cost of merchandise imports, interest payments, and these other ancillary items from export earnings generates the current account balance.

As column 5 indicates, with the exception of Venezuela, every Latin American debtor nation ran a current account deficit in 1985. In other words, after all expenses are taken into account, debtor nations were still not generating enough export earnings to operate on a pay-as-you-go basis. Comparing these current account deficits to the amount of new loans envisioned by the Baker Plan leads to the inescapable conclusion that the vast

majority of new funds will be used to pay interest, rather than to stimulate growth, imports, and development.

Impact on U.S. Farm Economy

Although there is little chance that the Baker Plan will promote increased U.S. exports to Latin America, there is a significant chance that it will lead to further declines in international commodity prices and U.S. farm exports.

A good example of the adverse impact the Baker Plan could have is the recently announced \$350 million World Bank loan to Argentina. The World Bank announcement stressed that this loan was proof that the Bank can dispense its share of the money called for in the Baker Plan. What the announcement failed to highlight is that Argentina is getting its \$350 million World Bank loan on condition that it reduce its tax on agricultural exports in order to expand the amount of land devoted to wheat and soybean production.

Under the existing export tax, Argentine farmers do not receive the prevailing world market price when they export their crops. Instead, the government claims approximately 35 percent of the world market price in the form of an export tax. Farmers keep the remaining 65 percent. According to the World Bank, this tax constitutes a serious impediment to exports. Reducing it, therefore, should encourage Argentine farmers to boost exports -- primarily wheat, corn, and soybeans -- by as much as 6.5 MMT, according to official World Bank projections.^{20/}

The World Bank recognizes that, in the current economic environment, boosting food exports may reduce world market prices. But it believes that falling prices will not place an intolerable burden on Argentine farmers. In the first place, it notes that "there is substantial scope for greater use of fertilizer and other inputs and for investment in infrastructure and equipment to enhance production."21/ Argentine wheat yields, for example, are only 70 percent of those in the United States, "in large measure, reflecting the use of insufficient technological packages in response to unfavorable pricing policies."22/ Reducing the export tax, the World Bank believes, will increase export profitability and, consequently, the incentive to employ better "technological packages."

The World Bank forecasts that higher yields resulting from modern technology will reduce per unit costs faster than the increased output reduces world market prices. Consequently, it reports that "in the event that international commodity prices decline even further than anticipated, Argentina should be able to continue to compete and find suitable markets for its products because of its competitive production advantage."23/

The World Bank analysis leaves two important questions unanswered. Who will purchase Argentina's additional agricultural exports? And since world export markets are not expected to grow rapidly, which country's exports will decline so that Argentina's exports may increase?

There would appear to be several potential customers for Argentina's additional agricultural exports. One obvious candidate is the Soviet Union, currently Argentina's biggest grain customer. The Soviet Union was recently awarded a contract to expand and modernize grain handling facilities at Bahia Blanca, Argentina's second largest port. After the expansion and modernization work is completed, annual grain export capacity is expected to increase by approximately 5 MMT. The Argentines might pay for this port modernization project by increasing their grain shipments to the Soviet Union. If so, Baker Plan funds will help to ensure that the Soviet Union will not need to increase its U.S. grain purchases. (Of course, as a result of the recent nuclear reactor accident, the Soviets may increase their grain purchases from a wide variety of foreign suppliers, in which case some of the adverse impacts on U.S. farmers could be reduced.)

Another obvious candidate is Japan. The Reagan Administration is currently pressuring the Japanese to take a more active role in resolving the debt crisis. If the Japanese comply by increasing their purchases of Argentine farm products, U.S. farmers could once again be the biggest losers. Japan is currently the number one market for U.S. agricultural exports. Although current trade frictions with the United States would seem to militate against Japan reducing its purchases of U.S. farm products, the Japanese could decide to comply with the Reagan Administration's wishes by refusing to increase their consumption of U.S. farm products.

In this respect, it is also important to point out that the recent decline of the dollar against the yen will not give U.S. farmers a competitive advantage over Latin American farmers. As part of their economic adjustment programs, both Argentina and Brazil devalued their currencies and then pegged them to the dollar. Consequently, both the austral and cruzado will rise and fall in tandem with the dollar and will always remain below the dollar in value. In other words, Argentina and Brazil will appropriate a significant portion of the benefits that U.S. farmers hoped to reap from a falling dollar.

A final set of candidates for purchasing the additional Argentine farm exports is Brazil and Mexico. Both nations might arrange to barter oil and manufactured goods for Argentine farm products. This barter arrangement could benefit the banks at the expense of U.S. farmers and U.S. export manufacturers. Argentina would reduce the amount of dollars it spends importing oil and manufactured goods. Brazil and Mexico would reduce the amount of scarce foreign exchange they spend purchasing U.S. food exports. In effect, all three debtor nations will have more dollars to pay the banks because they would all be purchasing less from the United States.

Impact on International Financial Institutions

As this analysis indicates, in deciding how to evaluate the Baker Plan, U.S. businesses, workers, and farmers must decide whether this most recent Administration initiative is in their

best interests. Will more loans whose primary purpose seems to be ensuring that debtor nations continue paying interest to commercial banks help U.S. farmers and U.S. exporters? Or will they merely continue to preserve bank profits at the expense of U.S. farmers and U.S. exporters?

Policymakers must also begin to examine the way in which the Reagan Administration is transforming the international financial institutions in the wake of the debt crisis. International financial institutions, such as the World Bank, the Inter-American Development Bank, and the IMF have always played a crucial role in promoting economic growth, trade, and development. The IMF ensures that member nations adopt effective adjustment policies designed to eliminate short-term balance of payments problems. The World Bank was chartered to help developing nations finance long-term development projects. Both institutions are charged with fostering sustained, orderly world growth and an environment of open markets and free trade. Neither was meant to function as a debt collection agency for the banks or to stifle world trade and growth in order to preserve bank profitability. Yet that is how the Reagan Administration is using them.

ALLEVIATING THE BURDEN ON U.S. FARMERS

Critics charge that the IMF and World Bank are the major cause of the problems outlined above. That indictment, however, assumes that the policies advocated by Administration officials

and implemented at their direction by both the World Bank and IMF were the only feasible way of containing the debt crisis. Fortunately, that is not correct. A careful examination of the wide range of alternatives indicates that there are a number of ways in which the Administration could have minimized the damage to the U.S. economy while, at the same time, preserving the integrity, safety, and soundness of the commercial banking system.

As the following two illustrative numerical examples indicate, a different set of policies would have yielded substantial benefits to the U.S. economy without imperiling the profitability of the nine money center banks. Similarly, neither example would have absolved debtor nations from undertaking needed structural reforms and eliminating corruption and capital flight. On the contrary, both could have been premised on continued economic adjustment and designed to facilitate and finance that process.

Example I

One possible approach would have been to ask the commercial banks to reduce or eliminate their spread -- the difference between the interest rate they charge on loans and the interest rate they pay for loanable funds -- on loans to financially troubled debtor nations. Under this approach, banks would have no longer earned profits on their Latin American loans, but they would not have lost money on them either.

According to a December 1985 Department of State report, Latin America's 1985 debt to private creditors, primarily commercial banks, totaled \$309 billion.²⁴ If banks had eliminated their 125 basis point spreads, Latin America's debt service costs would have declined by \$3.86 billion, or 10 percent of the interest actually paid in 1985. The amount of export earnings devoted to interest payments, and therefore not available for purchasing U.S. products, would have declined from 36 percent to 32 percent.

A reduction of this magnitude would not have imposed a dangerous burden on the U.S. commercial banks involved. According to the Department of State, the nine U.S. money center banks held one-sixth of the total Latin American debt owed to private creditors. Their pretax, pro-rata share of the \$3.86 billion debt service reduction, therefore, would have been \$643 million. By comparison, their combined 1985 after-tax profits were \$3.4 billion, even after including the \$337 million loss at Bank of America.

In after-tax terms, this \$643 million decline in revenues translates into a \$321 million reduction in after-tax profits. Their 1985 after-tax profits would have been 10 percent lower than initially reported. However, combined profits at the nine money center banks would still have been above \$3 billion.

Clearly, reductions of this magnitude do not represent a threat to the safety and soundness of the banking system; in fact, they do not even pose a threat to the profitability of the

nine most exposed money center banks. However, while this alternative policy would not have placed an onerous burden on the U.S. commercial banking system, the potential benefit to U.S. farmers and export manufacturers could have been quite substantial.

For example, debtor nations would have been under less pressure to expand their exports and less constrained to reduce their imports. For U.S. farmers, this would have meant an opportunity to increase U.S. agricultural exports to Latin America, the prospect of less competition in world export markets from Latin American producers, and the possibility that prices for U.S. farm products would be under less downward pressure.

It is important to point out that these changes would have merely slowed the growth of Latin America's wheat and soybean exports and moderated the decline of U.S. exports. Even after this change, U.S. exports would still be declining and Latin America's exports would still be growing. But the injury inflicted on U.S. farmers by the Administration's debt crisis policies would be reduced.

Example II

A second possible approach would entail limiting interest payments to a certain percentage of each debtor nation's export earnings and specifying that banks must write-down the value of their outstanding loans by a certain amount during every year in which Latin American debtor nations hit this revised interest

payment target. For example, the Administration could have advocated limiting Latin America's debt service charges to 25 percent of its export earnings and telling banks to reduce their outstanding principal by 1 percent during each year in which Latin American debtors pay this new debt service charge.

If implemented at the beginning of 1985, this policy option would have reduced Latin America's annual interest payments by \$12 billion. And if the nine money center banks absorbed their proportionate share of this burden, their before-tax profits would have declined by \$2 billion. After-tax profits would have declined by a little more than \$1 billion. Although this sounds like a steep reduction, it would merely have slowed the rate of growth of bank profits. The combined 1985 after-tax profits at the nine money center banks would still have been above the 1984 level and only 14 percent below their 1982 level. Clearly, a reduction of even this magnitude would not have represented a serious blow to bank profitability.

In addition to slowing the growth of bank profits, this option would have reduced the annual value of the combined assets of these nine banks by \$500 million, or 0.07 percent. However, as the Federal bank regulators at the Federal Reserve Board, Comptroller of the Currency, and Federal Deposit Insurance Corporation emphasized in their recent discussion of Financial Accounting Standards Board Rule 15, banks do not have to incur a charge-off merely because they have reduced the interest rate or the outstanding principal on a particular loan.^{25/} According to

Financial Accounting Standards Board Rule 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, concessions to debtors result in a charge against bank capital only when the sum of future principal and interest payments falls below the amount of principal outstanding at the time of the restructuring. Since the amount of debt service reductions envisioned in this option would not come close to reducing future payments to the level at which write-downs are required, this option would neither impair bank capital nor endanger the safety and soundness of the commercial banking system.

While the financial impact on the banks would not have been draconian, the benefits to the U.S. economy, and also to the commercial banks, would have been quite substantial. The share of the benefits accruing to the U.S. economy should be much larger than the share of the burden absorbed by U.S. banks. U.S. money center banks hold only one-sixth of all commercial bank loans to Latin America. But nearly 50 percent of the trade surplus that Latin America needed to pay interest was generated by reducing its purchases of U.S. products. This suggests that a \$12 billion reduction in Latin America's debt service charges could have increased U.S. sales to Latin America by as much as \$6 billion, while after-tax profits at the commercial banks would have declined by only \$1 billion. In other words, the benefit cost ratio for the U.S. economy is approximately six to one.

These examples suggest that, in the future, some negotiated arrangement limiting debt service payments may be the best way to

avoid more radical, unilateral actions by Latin American debtors. During his July 1985 inaugural address, for example, Peruvian President Alan Garcia announced that his country would devote only 10 percent of its export earnings to interest payments. As the debt crisis continues to fester, with no permanent solution in sight, additional Latin American leaders might conclude that this sort of solution is the only way to restore growth and improve standards of living. If they unilaterally begin to limit their country's interest payments to 10 percent, or even 15 percent, of export earnings, the impact on bank profits, capital, and solvency will be even more severe.

Some sort of realistic assessment of the ability of debtor countries to service their debt holds out the promise of making an effective frontal attack on the debt crisis, in contrast to current policies which only postpone a permanent solution, add to Latin America's external debt, and leave the prospect of loan defaults and financial ruin hanging over the banks. If policies were to be adopted along the lines of the second example, Latin America's debt burden would begin to decline. And, in fact, after several years, if commodity prices start rising and interest rates stay at their current levels, 25 percent of the new, higher level of export earnings may be more than sufficient to pay debt service at the then-prevailing market rate of interest on the new, lower level of outstanding principal. Consequently, banks would resume earning a market rate of return and debtor nations could use the excess payments either to boost

their imports even more or to begin retiring their debt even faster.

Finally, the potential future costs to the banks and to the U.S. economy of not adopting alternative policies may exceed the costs to the banks of implementing these reforms. Current Administration policies offer Latin American debtor nations little hope that their debt service burden will be eased anytime soon. Consequently, the pressures on Latin American leaders to default or declare a debt payment moratorium could increase substantially. This, in turn, could force banks to write-down their Latin American loans by an amount that would impair their capital.

As capital declines, a bank's ability to weather losses on other portions of its portfolio also declines. In addition, the amount of loans it can have outstanding must also be reduced. In general, current regulations require banks to reduce their outstanding loans by \$16 for every \$1 decline in their capital. In other words, a write-down of Latin American loans could generate an unwanted and unhealthy domestic credit crunch. U.S. consumers and businesses would be deprived of credit. Many would face financial ruin. Upward pressure on interest rates could resume.

Alternatives to present policy could help to avoid this prospect. They might slow the growth of bank profits, to be sure, but, in return, a long-term solution to the Latin American debt crisis would be in place. And, just as important, the

• solution would not require inordinate sacrifices by other sectors
• of the U.S. economy.

FOOTNOTES

1. Economic Commission for Latin America (ECLA), Preliminary Overview of the Latin American Economy 1985, Santiago, December 1985, Tables 12-15.

2. Department of State, Report to Congress on Foreign Debt in Latin America, December 1985, Table 4.

3. Ibid., Table 8.

4. This strategy is outlined by then-Treasury Secretary Donald Regan in Hearings on International Debt, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 4, 1983.

5. Department of State, op. cit., Table 6.

6. ECLA, op. cit., Table 7.

7. "U.S. Agricultural Exports Up 8 Percent to a Record \$43.8 Billion in Fiscal Year 1981," Foreign Agricultural Trade of the U.S. (FATUS), U.S. Department of Agriculture, Economic Research Service, November/December 1981, p. 5.

8. For U.S. agricultural exports to Latin America in 1981, see ibid., Table 4. Statistics for 1985 are from "Increased Supplies Dampen U.S. Farm Exports," FATUS, November/December 1985, Table 6.

9. U.S. agricultural exports to the Soviet Union are detailed in "Increased Supplies Dampen U.S. Farm Exports," ibid., and "Soviet Imports of U.S. Agricultural Products Since the 1980 Sales Suspension," FATUS, May/June 1983, Table 1.

10. ECLA, op. cit., Table 10.

11. See Donna U. Vogt and Barry Carr, Patterns in Trade of Selected U.S. Agricultural Exports, Congressional Research Service, Report 86-510 ENR, January 30, 1986, Table 14.

12. Ibid., Table 17.

13. See "Undernourished Children," in Foreign Broadcast Information Service, Daily Report, Latin America, April 28, 1986, p. D1.

14. Statistics on recent bank failure rates are reported in Randall A. Killebrew and Michael Fitch, "Statement of the American Bankers Association on the Problems of Agricultural

Credit," Presented to the Committee on Banking, Housing, and Urban Development, U.S. Senate, March 6, 1986, p. 3.

15. See Emanuel Melichar, "Farm Financial Experience and Agricultural Banking Experience," Statement before the Subcommittee on Economic Stabilization of the Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, October 23, 1985, Table 12.

16. See testimony of International Trade Commission Chairwoman Paula Stern, "The Sovereign Debt Problem and its Impact on U.S. Foreign Trade," Statement for the Subcommittee on International Development Institutions and Finance, Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, March 19, 1986.

17. Historical data on syndicated bank loan spreads is contained in Ricardo Ffrench-Davis, "International Private Lending and Borrowing Strategies of Developing Countries," Journal of Development Planning, No. 14, 1984, p. 142-143.

18. See ECLA, op. cit., Table 18.

19. Statement of the Honorable James A. Baker, III, Secretary of the Treasury of the United States, Before the Joint Annual Meeting of the International Monetary Fund and the World Bank, October 8, 1985, Seoul, Korea.

20. These projections are contained in Report and Recommendation of the President of the International Bank for Reconstruction and Development to the Executive Directors on a Proposed Agricultural Sector Loan in an Amount Equivalent to U.S. \$350 Million to the Argentine Republic, Report No. P-4161-AR, March 14, 1986, Annex VII, p. 2.

21. Ibid., p. 8.

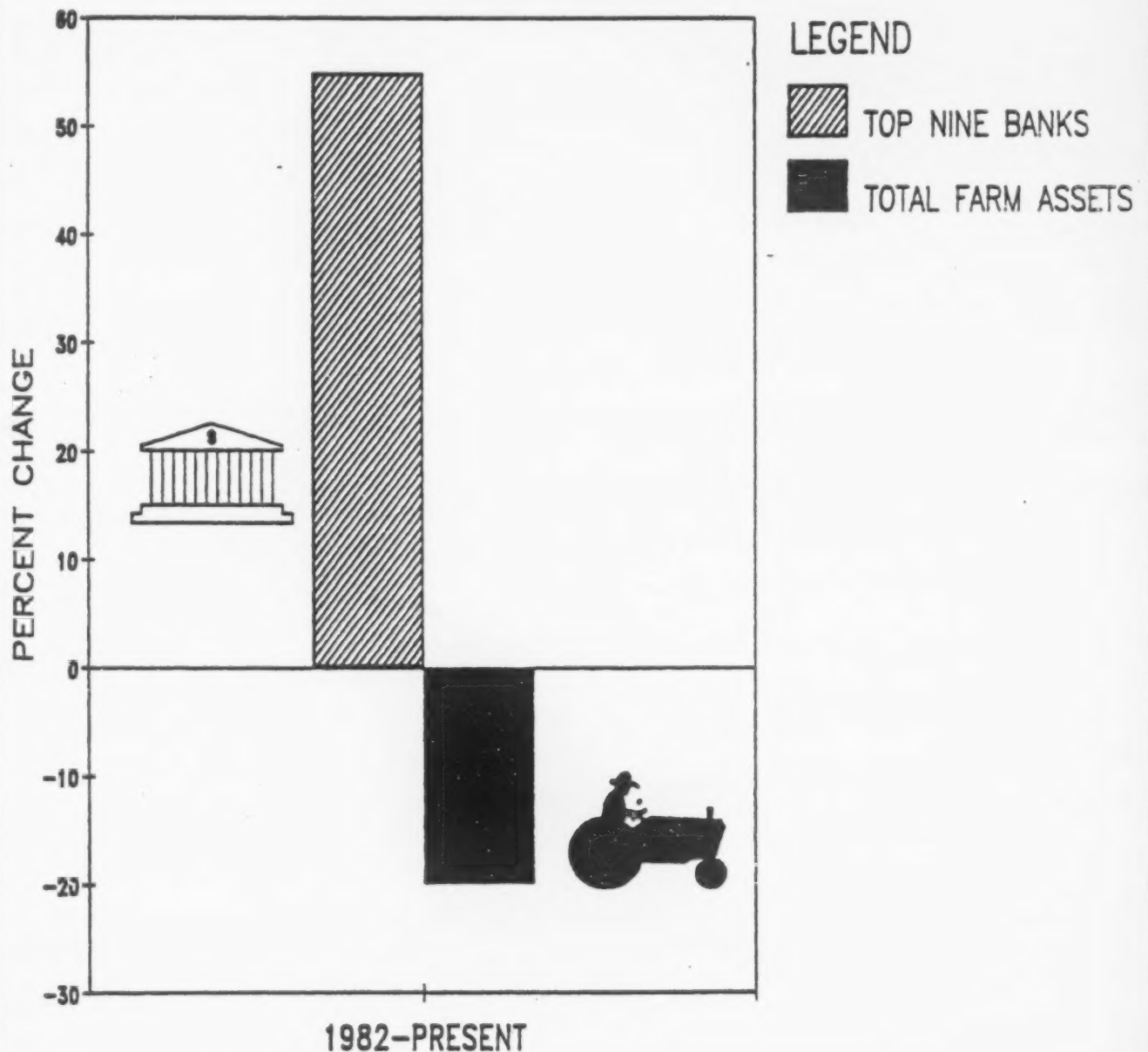
22. Ibid., p. 9.

23. Ibid., p. 21.

24. Department of State, op. cit., Table 4.

25. See, for example, statement of Robert L. Clark, Comptroller of the Currency, Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 11, 1986.

STOCK VALUE OF MAJOR FOREIGN LENDER BANKS COMPARED TO MARKET VALUE OF TOTAL U.S. FARM ASSETS



PREPARED BY THE JOINT ECONOMIC COMMITTEE